The Kent Reliance
Buy to Let Britain report

Edition Five

KentReliance

A foreword

Welcome to the fifth edition of Kent Reliance's half-yearly Buy to Let Britain report, which examines the key trends in the private rented sector (PRS) and the Buy to Let (BTL) mortgage market.

2016 has seen a prolonged period of uncertainty and breakneck change for the sector. The first quarter of 2016 was one of the busiest ever for the BTL market, as investors hurried to complete purchases before an additional 3% stamp duty levy for second homes came into effect. This edition tracks what has happened since – a period that has not been without incident.

In the last six months, the BTL market has tried to find its 'new normal' and the industry has faced yet further intervention in the form of the Prudential Regulation Authority's (PRA) recommendations for Buy to Let underwriting. Meanwhile, investors have had longer to digest and react to recent tax changes due to be introduced from April 2017 – all against the backdrop of the referendum vote and the economic and political disturbance it has brought. The raft of measures on the radar for the BTL sector were in part aimed at improving home ownership levels, so it is ironic that they are likely to achieve the opposite, with even greater upward pressure on rents, combined with the prospect of declining real incomes, likely to stretch affordability measures even further.

In this context, we look at how landlords and lenders alike are reacting to the successive blows of taxation and regulatory change, as the PRS remained firmly placed in the political crosshairs. We examine how landlords have reacted to the increasing cost of running their business, the knock-on impact of higher rents for tenants, not to mention the rocketing popularity of investors securing finance through limited companies.

We also calculate the current size of the private rented sector and its value, analyse the rate at which it is growing, and the returns landlords are currently seeing.

We hope you enjoy reading our Buy to Let Britain report.

Andy Golding, CEO, Kent Reliance, OneSavings Bank plc

Andy Golding, Chief Executive Officer

Andy joined OneSavings Bank as Chief Executive in 2012, and in 2014, led the business to become the first bank to float on the London Stock Exchange in a decade. He has more than 30 years' experience in financial services and has held senior positions at NatWest, John Charcol and Bradford & Bingley. Prior to joining OneSavings Bank he was the Chief Executive of Saffron Building Society, where he had been since 2004. He has held a number of positions with industry institutions, including membership of the Building Societies Association's Council and the Council of Mortgage Lenders' Executive Committee, of which he is still a member. Andy consistently and vocally champions the importance of a thriving private rented sector. He is passionate about simplicity and fairness in financial services and is a published author on the subject of financial education. OneSavings Bank trades primarily under the Kent Reliance, InterBay Commercial, Heritable Development Finance and Prestige Finance brands.

Executive summary

Market overview

- Landlords' confidence bounces back from record low, although three quarters view further government intervention as the biggest threat to investment
- Number of loans issued to limited companies in 2016 hits 100,000 as landlords act before tax changes
- A quarter of investors are considering incorporating or transferring property to spouses
- PRS expands to 5.3m households, although growth rate slows to 5.4%
- Value of landlords' holdings climbs £174bn in last year, now standing at £1.3trn

Landlords

- Average rents hit record high of £881 pcm despite post-stamp duty surge in supply, although rate of increase slows
- Tenants set to see rents spiral as landlords pass on higher costs; a third of landlords expect to increase rents by over 5%
- Landlords collect a total of £4.6bn a month in rent in Great Britain, up by 8% year-on-year
- Despite landlord fears over future impact of tax changes on profits, gross total returns stand at an average of £31,693 per property, equivalent to 14.4% per year
- Total annual returns across the country climb to £158bn, with London accounting for largest share by far

Lenders

- Cumulative effects of government intervention see remortgaging dominate lending
- Remortgages now account for two thirds of Buy to Let lending, up from less than half in 2014
- Buy to Let purchases yet to regain level seen before stamp duty rush, but landlords more likely to expand than shrink portfolios
- New PRA underwriting standards for Buy to Let to see deposit sizes climb

Confidence returns despite rapid changes for property investors

- 54% of landlords now positive about their portfolios, bouncing back from record low in Q2 2016
- Three quarters see further government intervention as key threat

The last two years have seen interventions in the PRS come thick and fast. The announcement of changes to the tax treatment of mortgage interest and the wear and tear allowance were followed swiftly by the additional stamp duty levy on second homes. The PRA then announced new regulations for mortgage underwriting. Under the new standards, lenders must take a much broader view of affordability, including the impact of revised tax rules. However, importantly, they must apply a minimum interest rate stress test of at least 5.5% for the first five years of a mortgage. This ultimately means many investors looking to secure finance for new investments next year will need to provide larger initial deposits. This is all set against an economic and political backdrop of the UK's decision to leave the EU.

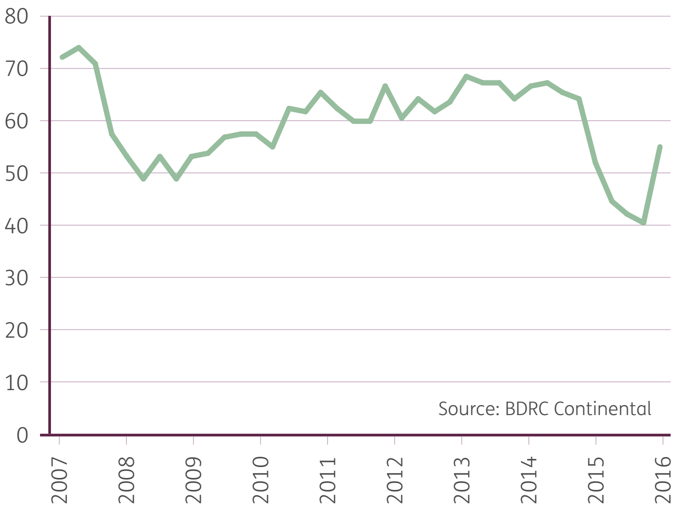
Investors have had to roll with the punches. It is clear they are starting to do so.

In a survey of 900 landlords, run in association with BDRC Continental in the third quarter of 2016, confidence has rebounded from all-time lows. 54% of landlords now hold a positive outlook for their portfolios, up from a low of 39% in the second quarter of 2016, following the additional stamp duty levy coming into power. The prospect of Brexit, too, is failing to prevent confidence climbing back. 54% of landlords now see Brexit having either a positive impact or no impact on their business – up from 45% immediately after the vote. Just a quarter (27%) now expect it to have a negative impact.

Moreover, 23% of landlords now expect to expand their portfolios over the next year – twice as many as the number who expect to sell down. While it is still too early to appreciate how landlords will react once the taxation changes actually come into effect from 2017, fears of a mass exodus from the market look likely to prove unfounded.

Nevertheless further action from the government remains a key concern. 76% of landlords see government intervention as the key threat to their property investments over the next year – a figure which has risen from Q1 2016 (73%). These concerns have been well founded. As well as hitting confidence earlier in the year, the quick succession of announcements on changes to tax relief and the additional tax levy contributed towards Buy to Let house purchase lending falling back to a level last seen in January 2015, suggesting the scale and timing of the changes may have been a bridge too far.

% of landlords positive about their business' prospects in next three months



Limited company lending moves into the mainstream

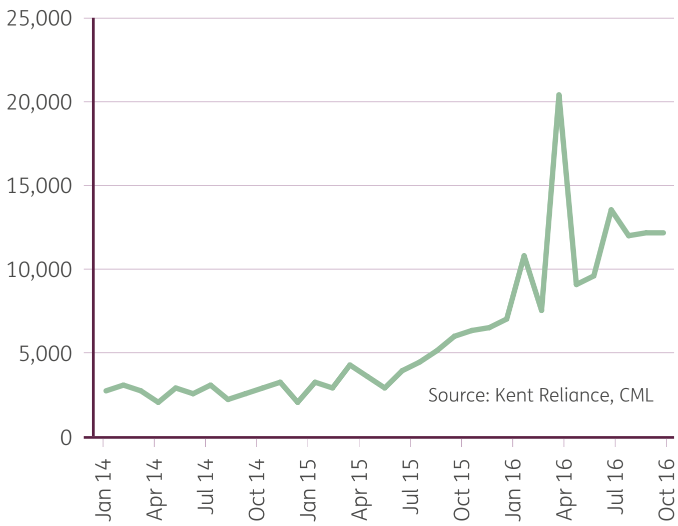
- Over 100,000 limited company loans have been issued in 2016 so far
- Total could hit 140,000 in 2016

2016 has seen landlords react to changes to the tax treatment of mortgage interest in two key ways: planning rental increases to cover increased costs, and managing their portfolios through limited companies – an approach that has become more popular as the year has progressed. In the first three months of the year, four in ten applications for Buy to Let mortgages have been via limited companies. Over the last three months, this has increased to six in ten applications.

Across the market, there have already been more than 100,000 limited company loans issued in the first nine months of the year. This is double the total amount in the whole of 2015, peaking with 20,500 in March alone, amid the stamp duty rush. The third quarter alone has seen 12,100 per month.

If the final quarter of the year follows the same trend as previous years, limited company lending in 2016 would total 143,000 loans.

Estimated limited company loans per month



Action follows awareness of tax impacts

- Over a quarter of landlords expect to be pushed into a higher tax bracket following changes
- 25% of property investors expect to incorporate or shift properties to spouses to mitigate tax changes

The reason for the continued growth of this type of mortgage is clear. Landlords have had a longer time to digest the tax change and take action; 85% now at least partially understand the financial implications. Following the reduced level of tax relief available to properties with mortgages, over a quarter (26%) of landlords expect the tax changes to push them into the higher tax bracket, with a greater proportion of income now taxable. This will affect those with larger portfolios more heavily, with over half of landlords with more than 20 properties expecting the changes will push them from the standard to higher tax bracket.

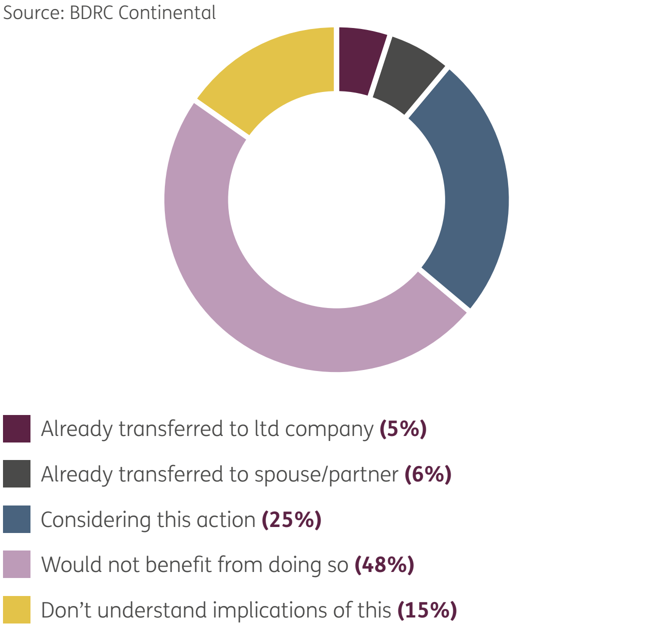
Making such a move will not be suitable for everyone, given the administrative and transactional costs associated, and should be made following independent tax financial advice, in particular where changing the status of properties already owned outside a company wrapper is concerned. However given the potential savings on offer for many, it is clear there is a strong and growing demand to incorporate. 11% of landlords state they have already incorporated, or have moved holdings to a lower rate tax-paying spouse or partner to limit their tax exposure, while a further 25% are considering doing so; this would account for half a million landlords nationwide. This figure may prove even higher once interest rates eventually rise, and the value of the lost tax relief increases.

Arguably the biggest changes have yet to take effect; the new tax rules don't start to bite until April 2017, when mortgage tax relief begins to reduce. This will act as a spur for many of those currently thinking of incorporating. Even if we assume the overall Buy to Let market does not grow next year, on current trends, limited company lending would increase by a further 14% in 2017, totalling 163,000 – nearly two thirds of all Buy to Let loans.

This form of lending will find support from lenders as it becomes a more commonplace mortgage product. According to Mortgages for Business' analysis, the proportion of Buy to Let mortgage products available to limited company borrowers has risen, but stands at just 16%. This is set to increase.

Landlords' sentiment towards incorporation or transferring property to spouse

Source: BDRC Continental



Strong foundations for sector's long-term growth

- Sector grows to 5.3 million households, although annual growth eases to 5.4%
- One in five households now in PRS, as affordability issues hit first-time buyer (FTB) activity

In the face of all this change, the PRS in Great Britain has continued to expand in 2016 on the back of sustained tenant demand, although the pace of growth has moderated slightly.

Our projections suggest that the PRS is currently growing at a rate of 5.4%, down from 5.5% in the first quarter, and 5.7% at the start of 2015. There are currently 5.3 million households in the sector, 19.8% of all households, compared to 5.0 million a year ago.

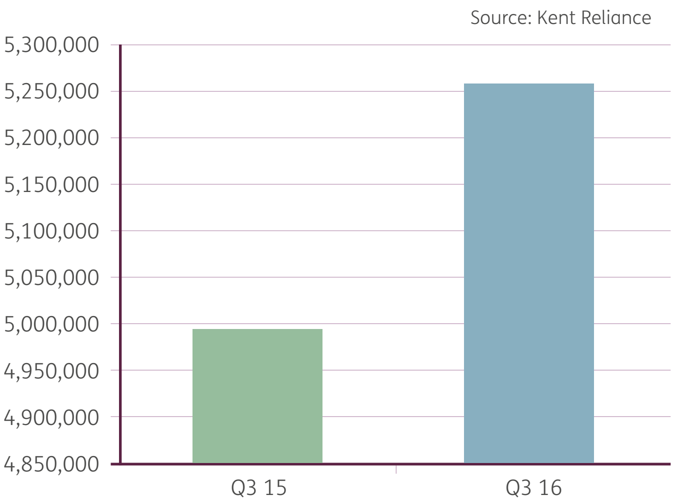
In our last edition, we detailed that the fundamental supply and demand imbalance in housing will continue to drive both house price growth and the growth of the private rented sector. Clamping down on Buy to Let is not going to rectify the underlying housing shortage or undermine house price inflation in the long term.

House price growth is still evident and outstripping wage inflation, with the prospect of higher inflation being muted in 2017 and beyond. Real disposable income could therefore reduce even further, putting housing affordability further out of reach and in turn, strengthening the demand for the PRS in the short term. With strengthening demand comes the opportunity for landlords to increase rents, especially if the supply of rental homes is constrained, as will be the case if BTL market growth is curtailed in line with the PRA's ambitions.

The personal tax changes for landlords were introduced to reduce growth in the sector, as part of a wider government housing policy that had a single focus: to increase home ownership. In the light of changes to the wider economic environment, most notably as a function of the EU referendum outcome, and its impact on the inflation outlook, that change now looks like it will drive an outcome exactly opposite to that intended.

Fundamentally, the only solution to the housing crisis is a building boom to create housing across all tenures. This will help alleviate the upward pressure on house prices, reducing affordability stress on first-time buyers, as well as supporting the steady growth of the private rented and social sectors. The Chancellor's moves to boost the supply of housing suggests a recognition of the problem. However, delivery of the sheer number of homes we need each year will not be an easy task, and the provision for 40,000 new affordable homes, for instance, will not be enough. In the meantime, the PRS will continue to pick up the slack. This will sustain tenant demand, underpinning landlords' power to increase rents to compensate for the higher costs of running a property portfolio.

Total households in PRS



Short-term supply boost eases rental inflation, but rises to come

- Rents rise by 2.4% to record £881 per month, slowing from 3.5% at the start of the year
- A third of landlords expect to increase rents by over 5% to absorb increased tax costs

Although average rents in Great Britain reached a record high of £881 per month in September, the rate at which rents are increasing eased in the last quarter.

Annual rental inflation slowed to 2.4%, down from 3.5% at the start of the year. This slowdown in rent rises has been driven by a short-term spike in the number of Buy to Let properties that came on to the rental market, following the sharp increase in the number of purchases ahead of the stamp duty deadline in April. For instance, ARLA reported the number of rental properties available for let has hit an 18-month high.[1]

This short-term dynamic serves to highlight the long-term supply constraints facing the private rented sector; even one of the biggest surges of properties entering the market in the sector's recent history has failed to turn it into a 'renter's market'. 29% of landlords have seen tenant demand rise for their properties in the last quarter – more than twice as many as have seen demand diminish. Equally, the number of landlords seeing void periods, a key indicator of oversupply, has remained steady at 31%.

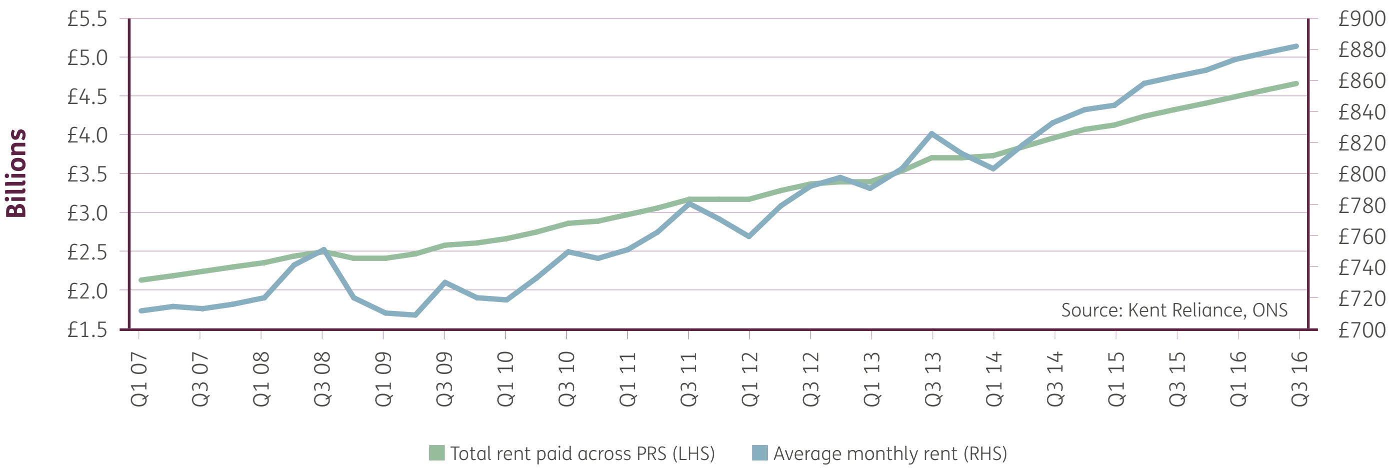
Moreover, the increased cost of managing a property portfolio will push up rents. One third of landlords plan to increase rents in the next six months – by an average of 5.4%. This would add £48 a month to the average household's rent - £571 a year. Overwhelmingly, the motivation for this is to meet the increased cost of operation that the changes to the wear and tear allowance and tax relief will bring (65%), while 43% cite strengthening demand. The move in the Autumn Statement to ban letting fees in England and Wales is ultimately well intentioned, given they are often unjustifiably high, but any additional costs landlords may bear as a result will simply be rolled into rents wherever feasible. While increases won't be on the same magnitude as those already planned, it is another upwards pressure on rents.

All of this points towards further rental inflation in the future – and likely higher than the extremely conservative 2% annual rental inflation that the PRA has asked mortgage lenders to plan for when underwriting.

With the size of the PRS expanding, and monthly rent still climbing, landlords are collecting a record £4.6bn in rent each month, 8% higher than a year ago. With the largest concentration of tenants and the highest rents in Britain, London tenants alone pay £1.8bn each month – 38% of the national total. The South East remains the next biggest contributor (£619m a month), followed by the North West and the East of England.

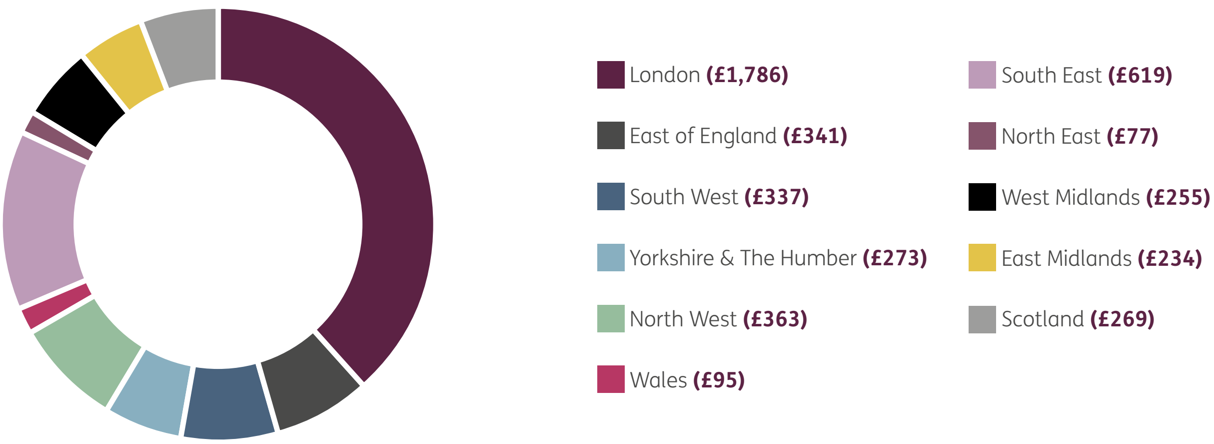
1. www.arla.co.uk/media/1045159/supply-of-rental-housing-has-increased-to-an-18-month-high.pdf

Total monthly rent vs average rent per property



Monthly rent paid by region (£m)

Source: Kent Reliance



Value of rented accommodation climbs to £1.3trn, although house price growth starts to temper

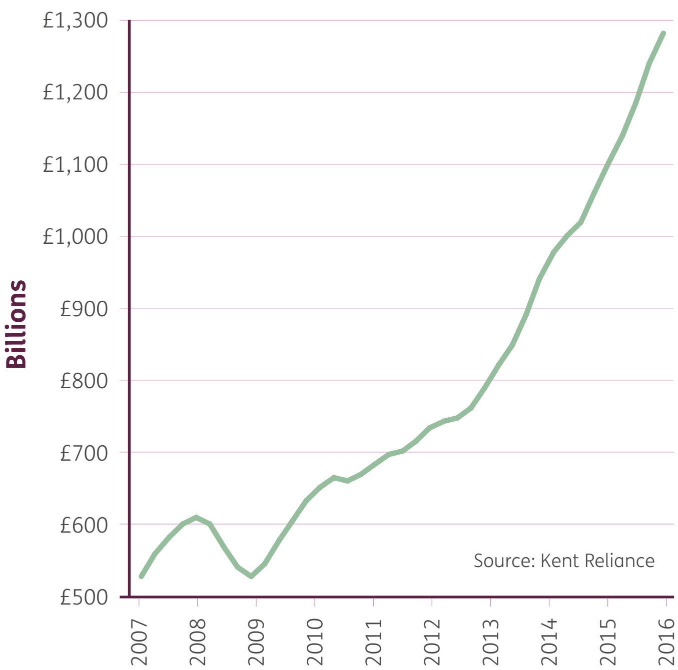
- PRS grows in value by £174bn in last year
- Property prices increase 9.7%, although this is slowing

A growing number of households, combined with consistently strong capital appreciation, has seen the value of the private rented sector hit new heights. The value of the PRS in Great Britain now stands at £1.3trn, climbing by 15.8% in the year to the end of September; £174bn had been added. In the last five years, the sector has grown in value by 81% – £573bn.

House price growth has been the main contributor to the growing value of the PRS, with the average rental property climbing in value by 9.7% in the year to the end of September, to £242,159. However, this is abating somewhat, with the lowest quarterly rate of increase (2%) since the end of 2015.

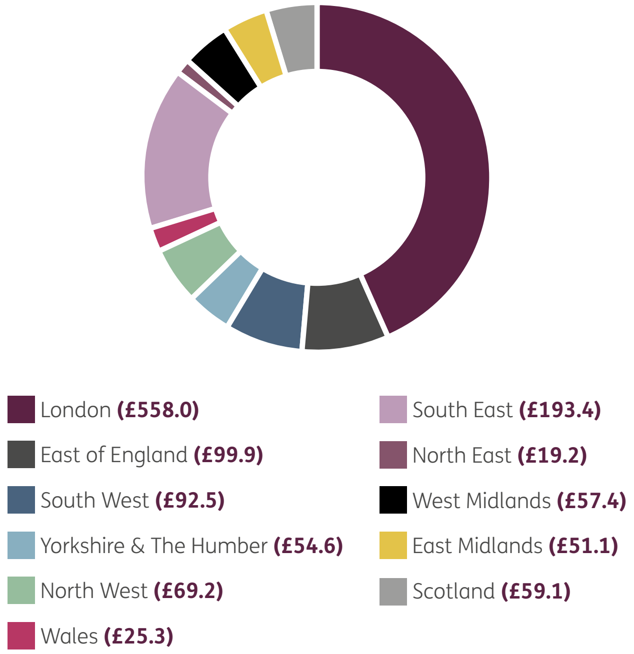
The value of the PRS varies hugely across the country. London's rented housing totals £558bn, 44% of the national total, and more than the combined totals of the next three regions in terms of value (South East, East of England, South West). London's dominance reflects a far higher share of private rented households, as well as much higher property values than elsewhere.

Total value of the PRS in Great Britain



Value of the PRS by region (£bn)

Source: Kent Reliance



Returns climb, but yields under pressure

- Despite fears over profitability, average annual returns stand at 14.4%
- Total annual returns hit £158bn, although house price inflation hits yields

As landlords factor in higher running costs, reduced profitability remains a concern. Two thirds of landlords believe that last year's Budget and Autumn Statement changes will decrease the profitability of their operations. However, this must be set against the strong returns landlords currently enjoy.

In the last year, landlords in Great Britain have seen an average annual gross total return of 14.4% per property, equivalent to £31,693. This is down slightly from the 15.2% seen in June. Once running costs and taxes are taken into account, the net figure will naturally be lower, especially for those landlords with higher gearing. These figures, however, highlight why property investment has sustained long-term appeal.

Across Great Britain as a whole, landlords have enjoyed total annual returns of £158.2bn, with London accounting for nearly half of this.

With house prices rising faster than rents, yields have been under pressure, falling to an average of 4.4% from 4.7% a year ago. Falling yields will prove increasingly problematic for investors if this trend continues into next year. Under the more stringent lending criteria set out in the PRA's new underwriting standards, landlords will need to demonstrate rental income is able to cover mortgage payments at a higher rate. Against a backdrop of strong tenant demand, many landlords may find they can simply put rents up to meet the mortgage cover requirements.

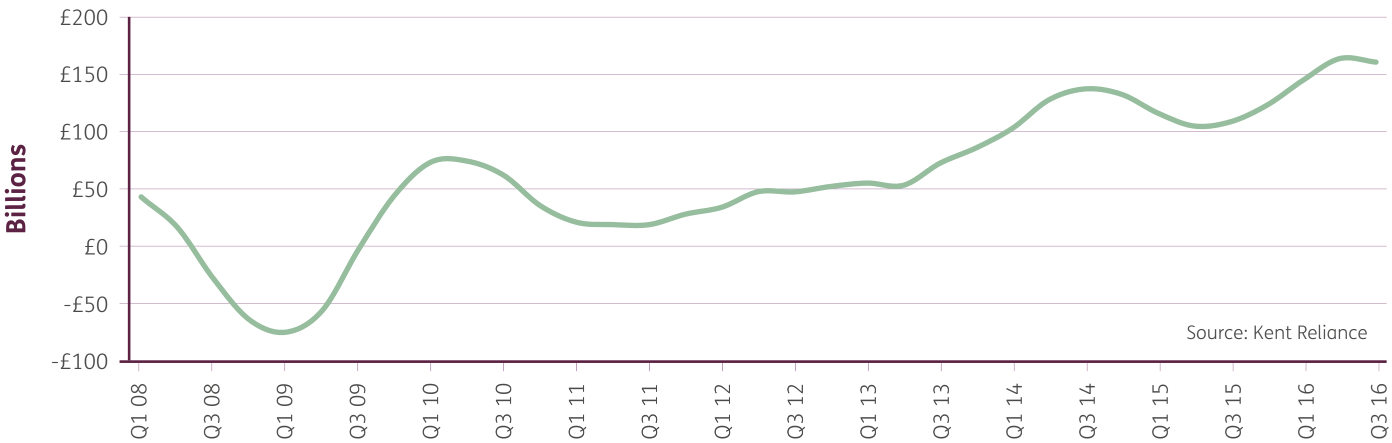
However, many investors will likely need to put up greater equity to secure finance for property purchases. The CML suggests this could be on average £25,000 to £35,000, although dependent on the region. Alternatively, as the CML notes in its detailed analysis of the BTL market, should investors move to maximise their leverage, they may increasingly seek lower-value, high-yielding properties. The net effect of this would be to increase the level of risk in the BTL market, the exact opposite of the PRA's intentions.

Current yields and total annual returns

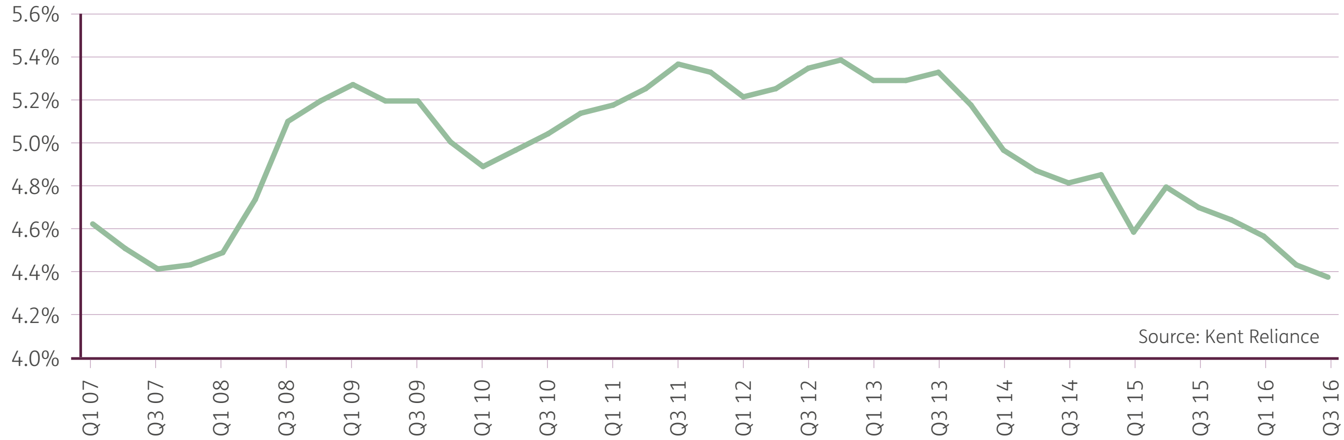
	Current yields	Total annual returns
London	3.8%	16.6%
East of England	4.1%	16.7%
South West	4.4%	10.6%
Yorkshire & The Humber	6.0%	10.7%
North West	6.3%	14.6%
Wales	4.5%	8.0%
South East	3.8%	14.8%
North East	4.8%	8.1%
West Midlands	5.3%	11.1%
East Midlands	5.5%	15.6%
Scotland	3.8%	5.6%
Great Britain	**4.4%**	**14.4%**

Source: Kent Reliance

Total annual returns across PRS



Gross yields in Great Britain



Remortgaging dominates mortgage market

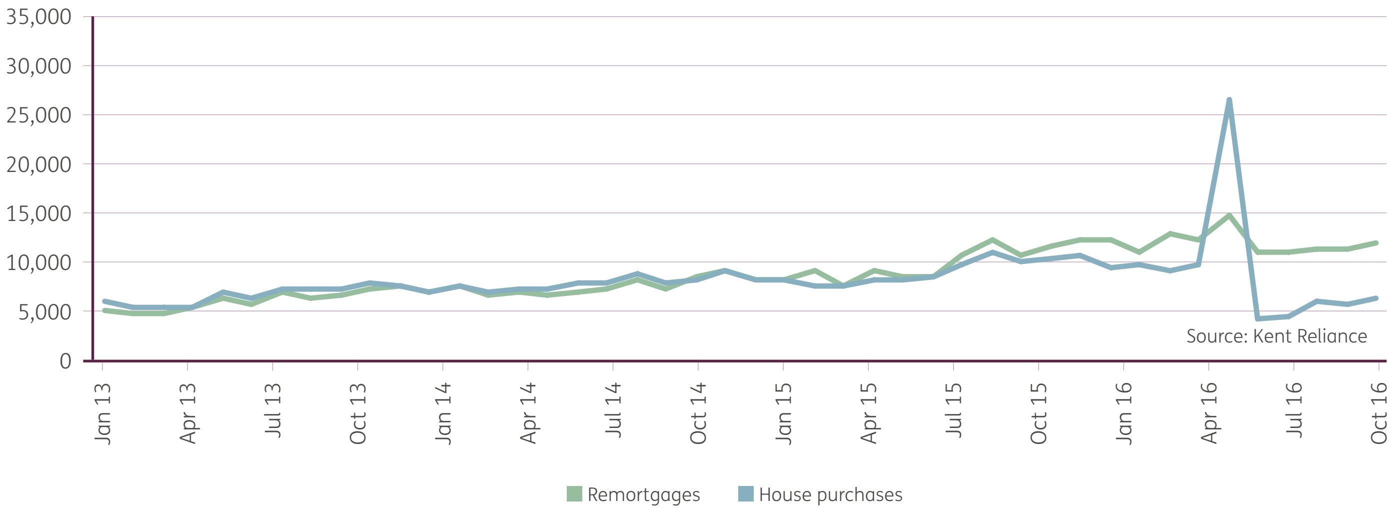
- Cumulative effects of government intervention see remortgages rise to two thirds of all Buy to Let lending
- Purchases fall a third, but likely to benefit from rush ahead of new lending standards

The cumulative effects of government intervention have changed the shape of the Buy to Let mortgage market in 2016. The stamp duty levy caused an artificial peak and subsequent trough in purchase activity, taxation changes have stimulated demand for limited company mortgages, while many lenders already began to take a more conservative approach to new lending following the announcement of the PRA's consultation paper in March. Added to this, the Bank of England's move to cut interest rates has helped drive the cost of finance down yet further.

All of this has created a heady cocktail for the remortgage market, at the expense of lending for house purchase. Two years ago, remortgages accounted for less than half of all Buy to Let mortgage lending, according to the CML. In August, they accounted for two thirds.

In fact, the number of Buy to Let remortgages rose by 11% in August compared to a year ago, while house purchase transactions are still more than a third lower. We expect to see this climb back again somewhat as the year ends, as many investors look to take advantage of current criteria before lenders begin to implement the changes recommended by the PRA. With remortgages also excluded from the new underwriting standards for now, this part of the market will also continue to grow.

Buy to Let lending: remortgage vs house purchase



Outlook

Following the personal taxation changes announced in 2015, investors have seen more clouds appear on the horizon in 2016 in the form of regulatory change. This continues the atmosphere of uncertainty and does nothing to diminish fears over further government and regulatory moves on the PRS. The decision to leave the EU added yet another worry for investors. However, landlords' confidence has started to bounce back as they digest both the impact of the government's intervention, and the lack of adverse impact the referendum has made to their businesses.

2017 will prove to be a pivotal year for the private rental sector. The changes to mortgage interest tax relief will begin, as will the new PRA underwriting standards.

Many landlords have already taken precautionary steps ahead of this, but many will face the reality of higher running costs. This will support rental inflation, and we expect rental inflation to accelerate to about 3% next year as the post-stamp duty surge of available rental accommodation becomes a thing of the past.

On top of this, with the prospect of real incomes falling next year as inflation kicks in, first-time buyer affordability will become more stretched, leaving the PRS to pick up the demand for housing.

Ultimately, this long-term demand and supply imbalance will not ease until housebuilding across all tenures begins to match growing demand. The government seems to be making the right noises, but we will still be able to judge it only by actions and results. The country's housing policy must be supported by sustainable, sensible lending – a worthy goal of the PRA's consultation. However, the cumulative effect of all this change could well mean the government has moved far further down the road of dampening Buy to Let purchase activity than it intended to. Any move that slows the widening of supply poses a risk to the long-term improvement of the housing market.

Despite all these challenges, the long-term role of the PRS has not changed. One fifth of all UK households now sit within the sector (and as high as a third in London), a proportion that is growing. The PRS will continue to grow to meet the housing needs of those who cannot afford to buy, and those that cannot be accommodated in social housing. There is unfortunately no alternative for the growing population of tenants. We estimate that the PRS will continue to expand, albeit more slowly. We expect the growth in the number of households to moderate to 5.2% next year, taking the total rented population to 5.6m households in 2017. Coupled with more modest house price growth, we forecast that the sector's value will rise to £1.4trn.

Methodology

Kent Reliance's research team analysed ONS census, ONS population and English Housing Survey data to establish the regional weighting of the private rented sector, its size and growth rate. Rental property prices are based on the average differential between rental property and house price data from Land Registry and Registers of Scotland, indexed against the ONS house price index. Rental data incorporates figures taken from Citylets, yield data from LSL Property Services and index data from the ONS. All rental and property value data has been weighted to account for the changing regional composition of the private rented sector. Buy to Let mortgage data is based on analysis of figures from the CML and ARLA. Unless otherwise stated, the data analysed is between 2007 and the third quarter of 2016, and references to "the last year" refer to the year to the end of Q3 2016.

Unless otherwise stated, all survey data is based on a survey of 900 landlords, conducted by BDRC Continental in the third quarter of 2016.

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